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National City Monthly Letter on Business and Economic Conditions

New York, June, 1954

General Business Conditions

THE business indicators have made another favorable showing in May. When all the returns are in they are likely to show a continuation of the April record of stable production, lessened unemployment, and increased new orders. The eight months' drop in industrial output halted in April, when the Federal Reserve Board's index leveled off at 123 (1947-49 = 100). With the rate of steel and automobile production a little higher, the May figure should be as good or better.

Taking general market activity into account as well as the production index, it now seems plain that March was the low point of the business decline. The turn for the better has not been sharp, and current indications favor stability rather than a marked rise. The important matter, however, is that the recession has not fed upon itself or turned into a downward spiral. Fears that curtailment of production and employment would lead to curtailment of consumption, to further cuts in production, and so on around the circle, have mostly disappeared. Tax reduction, the immense holdings of liquid assets available for a rainy day, abundant credit resources, unemployment compensation, and other stabilizing influences have helped sustain personal incomes and consumption, and thus have provided an anchor against spiralling effects.

Business confidence, which was gratifyingly strong all through the decline, remains optimistic. In fact, the disposition to take a rosy view has been so pronounced that President Eisenhower felt impelled at a recent press conference to caution against it. Many business men feel, however, that they have a sound basis for optimism in the steady, though moderate, increase in orders. Month after month, they have watched shipments exceed new business booked, and unfilled orders decline. Even after production was cut back, the decline continued. Now it is encouraging to see the gap between shipments and orders narrowing in a good many lines, and production leveling out. Businesses which for months were living off their inventories and letting their commitments run down now are buying more in line with current operations. For the most part, the increase has been gradual, but a few buying flurries have occurred, such as the scramble for cotton print cloths in mid-May.

How Much Inventory Adjustment?

The increase in orders is a signal that the two major forces behind the recent decline — inventory adjustment and the pruning back of defense contracts — have lost much of their steam. Only about a third of the companies surveyed in May by the National Association of Purchasing Agents were still reducing inventories of purchased materials. However, it would not be safe to assume that inventory reduction as a whole is ended. Neither manufacturers nor distributors as yet have succeeded in cutting finished goods stocks appreciably.

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Looking at the overall level of inventories, the progress in inventory adjustment seems disappointingly slow — a decline of only 1½ per cent from the peak last October. On the other hand, last spring business was building inventories at the rate of $6 billion a year, but by the first quarter of 1954 was reducing them at a $5 billion annual rate. From that viewpoint the adjustment seems much more impressive and accounts for the major share of the drop in production. The important present point is that while stocks may continue to decrease, the rate of change is likely to become more gradual. The progress made to date, the firmer tone in business, and the uncertainties of labor negotiations and the international situation all point in that direction.

A slackening in the rate of inventory reduction and return to buying more nearly in line with consumption eases the pressure on production. In most business cycles there is a period in which inventories are still going down at the same time that production is stable or rising. Evidently we are in such a period at this time.

The New Look in Defense

Whether the war in Indo-China, and the possibility of further American involvement in Southeast Asia, have stimulated buying would be hard to prove, one way or the other. Nevertheless, some business men may anticipate expansion of defense orders and a renewed stimulus to the economy. Defense Secretary Wilson has promised "a soul-searching review of our specific policies, plans, objectives, and expenditures".

In any event, the decline in defense expenditures and orders, which contributed to the business recession, has probably ended. The rescheduling of defense work within the past year has reduced deliveries and expenditures, but it has cut order backlogs at defense factories and their suppliers even more sharply. As part of the program to bring outstanding obligations under control, defense authorities have held the issuing of new contracts in this fiscal year far below the levels authorized by the budget. In turn, industrial procurement for defense production has been cut. Expenditures on defense have dropped about $6.5 billion (annual rate) from their peak in the second quarter of 1953. The slash in outstanding orders has been nearly twice as great. Some increase in ordering will be necessary in the near future just to maintain current levels of output.

National security expenditures in the first quarter were running well below the level budgeted for fiscal 1954, and even somewhat lower than the rate scheduled in the budget for fiscal 1955. Thus, under the current program alone, a slight rise might be expected in defense outlays during the year ahead. In any case, they are unlikely to decline.

Homes and Cars Still in Demand

Construction continues its record-breaking pace. The value of construction work in the first four months of 1954 was the highest for this period on record. Construction contract awards, also at a peak, promise sustained activity in the months ahead.

A substantial share of these gains reflects the high rate of private home-building, which in April was the highest for any month since September 1950. At current rates, the number of homes started this year may equal or exceed the 1.1 million started in 1953, whereas at the turn of the year even the optimistic forecasts indicated a decline of about 10 per cent. Contract data reveal that this upsurge has been concentrated in building single-family homes for sale or rent; such awards recorded a year-to-year gain of over one-fifth in the first four months of 1954. Construction of owner-occupied homes is about the same as last year, while multi-family housing is down sharply. The rise in so-called "speculative" home-building is largely an outgrowth of easy mortgage money, compared with the tight market last year. An increasing number of homes are being financed with 30-year no-down-payment mortgages guaranteed by the Veterans Administration. From a long-term point of view the soundness of such financing may be open to question, but in the short run there is no doubt that it is stimulating not only construction and the industries which supply it, but also sales of furniture, appliances, and all the other consumer durable goods which go into a new home.

Retailers were pleased with the results of sales in April; total sales advanced over March and approximately equaled April 1953. Much of the gain over March was attributable to the later date of Easter this year and to the excise tax reductions which went into effect April 1. Taking the two months together to avoid these distortions, total retail sales were within 2 per cent of March-April last year and 2 per cent above the January-February level this year on a seasonally adjusted basis. Department stores reported disappointing business in the first three weeks of May, as cold, rainy weather held back advance sales of summer merchandise.

Retail sales of durable goods have shown a marked recovery since January. In particular,

automobile sales have made a good showing. The divergent sales experience of the different makes has stirred up much comment, almost obscuring the favorable overall sales reports. But sales of new passenger cars in April topped half a million and this rapid pace was maintained in early May, according to preliminary reports. Ward's estimates that sales for the first half of 1954 will total more than 2.7 million, about 9 per cent behind 1953, but better than many industry observers expected. Dealers are achieving this sales record, exceeded in only three previous years, by hard selling.

New car stocks, however, are at record levels. Production has exceeded sales even in the best months this year. If dealers are to clear the decks for the early introduction of 1955 models, some adjusting of third quarter production schedules will be necessary. Even with the second half 10 to 15 per cent below first half levels, 1954 sales would add up to better than 5 million cars — a good year by any standards.

Is Government Doing Enough?

In summary, the trade and industrial reports present a picture of the production decline halted, the effects of inventory reduction and curtailed defense expenditure waning, sustained construction, investment, and personal consumption activity, and a pickup in new orders in many lines. The prophecy widely made six months ago that 1954 would be the second best business year in the nation's history seems on the way to realization. To most business men this is a reassuring rather than a dismaying prospect. They never expected that the boom levels reached in the spring of 1953 could be maintained. They accepted the need of adjustments, and knew that inventory accumulation and credit expansion would not go on indefinitely. They usually feel a little suspicious when business comes too easily, and when mistakes, waste, inefficiency, and low productivity seem to carry no penalty; and under such conditions they prepare themselves for a change. All of these elements have entered into the good spirit with which the recession has been borne.

Nevertheless there is a body of opinion which feels that the relative prosperity of the second best year in history is not good enough. The Congress of Industrial Organizations last month sponsored a two-day "full employment" conference which was addressed by various trade union officials. The tenor of the speeches was that the Administration has been following a "do nothing" policy in the face of "huge" unemployment, and that "we cannot stand still without really slipping backwards". The speakers called for broader unemployment insurance, increased minimum wage rates, higher social security benefits, massive public works programs, expanded housing construction, more liberal credit, increased personal tax exemptions and strengthened collective bargaining.

Two days after the foregoing conference, former President Truman in a speech at Atlantic City advocated a six-point program including a $3 billion a year increase in federal spending; increased personal tax exemptions; increased minimum wages; expanded unemployment insurance; elimination of the Benson farm program, in order to produce "true parity" of income for the farmers; and a vastly expanded housing program to double home-building activity.

The 1949 Experience

Passage of time and changes of position and viewpoint may quite understandably alter opinions as to economic policy. During Mr. Truman's Presidency, in 1949, the United States experienced a business recession very similar in extent and time to the 1953-54 decline. As was his duty, he offered leadership in policy determination. In January 1949, when the recession was just beginning, he made as President the following statement in his Economic Report to Congress:

> The recent appearance of wider areas in the economy where supply conditions have improved, where the pressure of demand has been reduced, and where price inflation has been halted or reversed, should be looked upon as a desirable development to be welcomed rather than feared. It marks the beginning of the process by which a more stable condition can be reached after a long period of rising prices. But these adjustments have not proceeded far enough to justify a cessation of concern about inflation.

In the Midyear Economic Report of the President, July 1949, Mr. Truman summed up the economic situation in this way:

> . . . The number of unemployed in June was 3.8 million, and acute unemployment problems have developed in certain localities . . . The decline in industrial production was rapid, and by June had reached 13 per cent below last fall's peak . . . Farm income was about 8 per cent below the first half of 1948.

But in spite of such evidence of recession, he went on to say in his July 1949 report:

> These facts show that our economy is still operating at high levels of employment and production. The kind of Government action that would be called for in a serious economic emergency would not be appropriate now.
>
> The economic situation does not now call for an immediate and sweeping expansion of public works . . .
>
> No changes in the tax laws which would result in a larger net loss in revenues would be justified at this time.

> **. . . It is desirable to recognize clearly that the objective [of] farm support prices is to maintain an adequate level of farm income and promote shifts in lines of agricultural production which will encourage an increase in the total domestic consumption of farm products.**

Mr. Truman's view of the 1949 situation, expressed at that time, proved to be sound. The subsequent inflation would have been worse, and the problems posed for both business and government would have been more difficult, if there had been more government intervention, more spending, and more inflationary policies to interfere with necessary inventory reduction and other adjustments. An attempt now to maintain and expand activity even beyond the peak 1953 rates by greater government intervention and deficit financing would be an open invitation to inflation. It would risk even greater adjustments when the bubble burst. The longer distortions are allowed to build up, the greater the price to be paid in unemployment and business failures when the time for adjustment arrives.

The present Administration has done much to ease the course of the current adjustment through monetary and fiscal policies, and has had a program of further measures before Congress for several months. The Administration's greatest contribution, however, has been the creation of an atmosphere in which business has the confidence to plan ahead for expansion and to lay the foundation for future increases in the nation's living standards.

It would be most unfortunate if the impression spread that political policies can and should stop every economic decline. Such misplaced optimism could lead to speculative excesses in securities and commodities markets, which would test our anti-recession defenses far more seriously than anything in the recent contraction. The combination of caution and optimism which tempered the activity of most business men during the last two years of the Korean boom has proved to be in itself the best prescription against a massive letdown.

Credit Developments

The better tone of business reports has again focused the attention of economists, bankers, portfolio managers, security dealers, and corporation treasurers on Federal Reserve credit and Treasury debt management policies. These latter policies, sensitive to the economic climate, have been directed over the past twelve months to insuring an abundant supply of credit as a check to the recessionary drift of business. The Federal Reserve has released funds into the market to build up excess reserves among the banks and has reduced from 2 to 1½ per cent the rate charged on borrowings by member banks. The Treasury, to aid the markets for mortgages and State and municipal bonds, has held back its program for funding public debt and for a full year now has refrained from offering any long-term bonds.

The construction boom continues at full pace, drawing for funds on heavy placements of mortgages and tax-exempt bonds. Deficit borrowings of the Federal Government are figured on about a par with 1953. What slackening has been observed in credit demands reflects the decline during the fall and winter in business and consumer buying, as well as the lapse of the excess profits tax on December 31. Business loans of the weekly reporting member banks on May 19 were $1 billion or 4½ per cent below the corresponding date of 1953. The big loss in business loan volume took the form of a failure of seasonal demands to mature last autumn followed by an abnormally heavy reduction in January. The drop since January, however, amounting to $500 million, has been no more than would be normal for this season of the year.

The main reduction in consumer buying has been in automobiles and other durable goods and shows up in a $900 million reduction in instalment debt during the first four months of the year. Nevertheless the total for consumer instalment debt at the end of April still ran $1.1 billion or 6 per cent ahead of April 30, 1953.

Treasury Financing

The Treasury successfully carried through on May 17 a $9 billion combined borrowing and exchange operation at the cheapest rates since 1949 or 1950. The cash offering of $2 billion four and three-quarter year 1⅞ per cent notes, to cover requirements up to June 30, was heavily oversubscribed and $2.2 billion were allotted. Another $2.9 billion of the 1⅞s were issued in exchange for 2⅝ per cent certificates of indebtedness due June 1. Holders of $1.8 billion of the maturing 2⅝s, including the Federal Reserve Banks, accepted an alternative offer of 1⅛ per cent one-year certificates, leaving less than $200 million to be redeemed in cash. The remnants of three bond issues due June 15, totaling $2.4 billion, were converted into 1⅞s to the extent of $2.1 billion, leaving $300 million to be paid at maturity.

The 1⅞ per cent cost of four-to-five year money was the lowest since 1950. The 1⅛ per cent cost of one-year money duplicates the low point reached in the 1949 recession. During May

the yield on 91-day Treasury bills slipped further, averaging 0.78 per cent, lowest since 1947 when yields on bills were entirely artificial, being pegged by the Federal Reserve Banks which held almost all of them.

While bills, benefiting from demands of corporations and foreign central banks as well as the easy reserve position of the banks, remained strong, tendencies became apparent in the U.S. bond market for buyers to take to the sidelines. Sellers seeking to take profits found that bonds did not move except at concessions of a point or two from the top prices registered in April. The new 4¾ year 1⅞ per cent Treasury notes, which traded May 5 on a when-issued basis at a half point premium, dipped to par on May 21 and fluctuated around that level during the remainder of the month. The 2½ per cent bonds of 1961, issued February 15, slipped from 103 on April 30 to 101¼ on May 28. The 3¼s of 1978-83 reacted from 110 to 108¾. Corporate, State and municipal bond issues, heavily inventoried among dealers, found buyers when price concessions were offered.

The retreat in prices of U.S. bonds, after the skyrocketing advance, had the wholesome effect of bringing yields a little closer to the foundations of genuine investment demand, where the buyer will come forward for the return offered rather than for a prospect of capital gain.

Credit Policy

The better tone of business reports contributed to the reaction in bond prices, as did disturbing news from Indo-China carrying the threat of a larger deficit. Another influence was the failure of the much-rumored drop in member bank reserve requirements to mature. In any case, the market was vulnerable to any lapse of buying interest, having attempted to discount too much in the way of further dosages of easy money.

Federal Reserve policy was continuingly directed towards keeping up the pressure on banks to enlarge their loans. The high prices of bonds contributed to the same end. The authorities, which had been intermittently buying and selling government securities in the open market to sustain and adjust the volume of surplus reserves among the banks, dropped out of the market for six weeks, March 31 to May 12, allowing free excess reserves to fluctuate around a $500 million average. During the two weeks ended May 26 the Reserve Banks reentered the market to buy $105 million bills, countering tendencies of the Treasury borrowing and month-end influences to harden the money market and giving reassurance that easy money was still the order of the day.

Principles for Tax Revision

As May drew to a close the Tax Revision bill, passed by the House on March 18, was still under study and amendment by the Senate Finance Committee. In preparation for its own decisions, the Committee held public hearings, running from April 7 to 23, attended by experts from the Congressional Joint Committee on Internal Revenue Taxation and from the Treasury who evaluated technical criticisms and suggestions on the complex 875-page rewriting of the Internal Revenue Code.

The hearings brought out a number of "bugs" in the new code and suggestions for clarification. Trade union leaders opposed the partial relief from double taxation of dividends (discussed in the April issue of this Letter), the liberalization of depreciation rules, and the carryback of losses for two years instead of one. Employer groups, on the other hand, expressed disappointment at the extension of the 52 per cent corporate income tax rate for another year, the requirement that corporations in the second half of 1955 start making advance payments against estimated current year tax liabilities, and the strictness of the depreciation rules.

On the whole, however, the hearings revealed widespread agreement that, while the new code is far from perfect, and there is room for differences of opinion on particular provisions, steps toward revision are long overdue. In the words of J. Cameron Thomson, testifying for the Committee for Economic Development: "Our present tax system is a residue of the 'thirties and 'forties — decades dominated by depression and by total war. We now face the problem of adapting our tax system to the requirements of the 1950's and 1960's."

The biggest questions, expected to emerge in the Senate debate, are:

(1) Should the Federal Government, to stimulate trade, embark on heavy deficit-financing by tax cuts running far beyond anything presently contemplated by the Administration?

(2) Should further tax relief, when granted, take the form of excusing millions from the income tax or of cutting tax rates so that relief is proportioned to burdens carried?

(3) What is the point of the provisions bolstering incentives to risk-taking investment?

The way these questions are answered will vitally determine the strength of the nation and the worth of the dollar in the decades ahead.

The Administration's Position

The Administration, committed to avoidance of further inflation and to a balanced budget objective, has been willing to tolerate moderate deficits for the time being to avoid economic dislocation resulting from reduction in government expenditures. As stated by Secretary of the Treasury George M. Humphrey before the Congressional Joint Economic Committee four months ago, "We are cutting taxes, even though we have not arrived at a budget balance . . . We must always anticipate the reduction of government expenditures and begin to transfer billions of dollars which the government will not be spending back to the taxpayers so that there will not be any sudden dislocation." Under this policy, which keeps a balanced budget within reach, the Administration takes an optimistic view of business prospects, and emphasizes the stimulus to employment, production, savings and investment afforded by the $7 billion tax reduction program.

On the question of whether, when additional tax relief can be afforded, exemptions should be raised or tax rates cut for all, the President has stated his position with firm conviction:

> When the time comes to cut income taxes still more, let's cut them. But I do not believe that the way to do it is to excuse millions of taxpayers from paying any income tax at all.
>
> The good American doesn't ask for favored position or treatment. Naturally he wants all fellow citizens to pay their fair share of the taxes, just as he has to do, and he wants every tax cent collected to be spent wisely and economically.
>
> But every real American is proud to carry his share of any burden. In war and peace, I have seen countless examples of American pride and of the unassuming but inspiring courage of young American citizens. I simply do not believe for one second that anyone privileged to live in this country wants someone else to pay his own fair and just share of the cost of his Government.

The Committee on Federal Tax Policy, a nonpartisan group headed by Roswell Magill, former Undersecretary of the Treasury, issued a report May 3 which met the common argument that taxes should not trench on the "minimum of subsistence". Recognizing that taxes are much too high, and stressing that reductions in government expenditures are the necessary prerequisite to tax relief, the report states:

> [Personal] exemptions are frequently rationalized by the theory that taxes should not trench on the "minimum" of subsistence. Actually exemptions are not granted for such a purpose and they do not in fact serve it.
>
> In the first place there is no determinable standard of the minimum of subsistence. It is a relative concept, varying according to time and place, local customs, and personal circumstances. . . .
>
> In the second place, the personal exemption principle is not applicable to many forms of taxation. . . . It has not been applied and could not be applied to excises, sales taxes, tariff duties, and other indirect taxes. Consequently, whatever the income tax exemption, the taxpayer still has his so-called subsistence minimum cut into by a host of other taxes. There is no way to leave the minimum untaxed.
>
> Finally the basic principle of the subsistence minimum exemption is open to serious question. After all, a certain amount of government is a necessity. Why should this necessity be treated differently from other necessities?
>
> We believe that it is a sound principle that every citizen should so far as possible be called upon to bear some share of the cost of his government. So long as most federal revenue is collected by taxing incomes, most incomes should be subjected to the tax. . . .
>
> For many years our American policy has been to broaden the base of the income tax. We have finally succeeded in bringing the exemptions and credits down to the present level of $600 for each. It would be a regrettable backward step if this accomplishment were now thrown away through raising the level of exemptions and credits.

No Partisan Matter

We need a tax structure that can give a balanced budget, progress and prosperity without clipping anything more off the value of money. Barring wars, we have realized those objectives in the past. We can have little chance of succeeding if we make it the central object of fiscal policy to take away from people who can afford to take a risk in business the wherewithal for doing so. Before we swallow the poison that inflation is the way to prosperity we ought to try the remedy of tax reform.

These matters are too vital to be made the prey of partisan politics. The Secretary of the Treasury, testifying April 7, reminded the Senate Finance Committee:

> The fact that our tax system needs revision is not something, incidentally, that the Republican Party has just suddenly proposed.
>
> For years congressional committees, with Democratic Chairmen and Democratic majority membership, have recommended revision. And Democratic minority members of the House Ways & Means Committee in 1947-48 when the Republicans were the majority in Congress, also recommended revision and specifically listed double taxation of dividends and more flexible depreciation as items needing prompt consideration.
>
> The general tax revision bill now before you, in other words, is not an arbitrary proposal of this Administration. Most of its major provisions have been developed after long objective study and — in the absence of compelling political reasons to the contrary — have over the years been supported on both sides of the aisle in both the House and the Senate.
>
> With most sincere conviction, I say that a modernization of our tax structure, as provided in part by the present tax revision bill, is something which this nation must have for continued growth and prosperity.

The Secretary emphasized that the Tax Revision bill is only a part of a program involving $7 billion tax reductions. On the bill itself he made three main points:

First, it is designed as a reform of the tax structure and not a tax reduction bill. We must keep this in mind as we hear the arguments against it which are based on the misinformation that it is cutting taxes in what some people think is "the wrong way." It is a reform program which has been proposed for years and years as needed reform.

Second, it helps millions upon millions of taxpayers who have been plagued by unjust and unfair hardships over many, many years.

Third — and most important of all — it will help our economy to grow; it will help new businesses to start, old businesses to expand, all businesses to modernize, and so help the creation of more and better jobs and better living for everyone.

In objecting to income tax reduction in 1947 the Democratic minority on the House Ways and Means Committee stated:

The sound approach toward postwar tax revision is to make a comprehensive study of the entire Federal tax system, including individual income taxes, corporate income taxes, estate and gift taxes, and excise taxes. Such a revision should aim at equitable adjustments, incentive effects, and sound administration under peacetime conditions.

The present Tax Revision bill has these aims.

Foundations of Industrial Strength

In support of his third and "most important" point Secretary Humphrey restated in language of eloquent simplicity the reasons why, in tax legislation, some attention must be given to the capital goods industries:

To have real prosperity in America, we cannot stimulate consumer buying alone. Large tax cuts to millions of individuals just to buy consumer goods is not enough. Millions of people in this country earn their living making heavy things — big lathes, generators, heavy steel and machinery that consumers do not buy. Such things are purchased by investors. Our tax program not only returns billions of dollars to consumers but also seeks to stimulate the investment of savings to buy the products of heavy industry — in the production of which so many millions of Americans get their livelihood. . . .

Nothing can so add to our national strength and preparedness as modernization of the whole industrial plant in America. There is nothing that can make more sure more jobs at which millions of people can earn high wages by producing more and better goods at less cost.

The Secretary also pointed out that, while the bill is basically a long overdue measure of tax reform, "it can help greatly the current economic transition" by giving a go-ahead signal on business projects around the country waiting for clarification of tax legislation.

Sustaining Investment

An impulse to risk-taking enterprise is timely. Investments in plant and equipment in recent years have been assisted by a backlog of pressing requirements built up during the war and by grants of accelerated amortization privileges in essential industries which, in effect, gave relief from tax burdens. These supports are running out. Opponents of the tax proposals to stimulate investment warn of the threat of depression but seem to forget that major depressions are always associated with sharp curtailment of private investment.

The supply of risk capital in particular needs energizing. The strong, well-established firm has been able to keep up with the times by highly conservative dividend-paying policies and plowbacks of undistributed profits supplemented as necessary by securities flotations, with bonds highly favored over stock issues because of the cheaper cost and the deductibility of bond interest on corporate income tax returns. Excessive bonded debt makes business vulnerable to an economic setback; business failures can snowball in depression, destroy the basis for credit which a prosperous modern economy must have, and bring the investment process to a halt.

The shortage of risk capital to smaller, less well-established companies, which need it the most, has been and remains most acute. Yet economic vitality demands the entrance and growth of new business. If more of the nation's savings can be induced to go into the ownership of industry, the cost of equity capital can be reduced and its availability increased.

The real value of saving is in making money available for physical investment. If savings stop, currency inflation becomes the sole means of financing physical investment. If saving goes on and physical investment stops, the result is stagnation. The Administration is wise in devoting at least a fraction of its tax relief to encouraging both flows. European nations are finding, in tax encouragements to investment, the formula for industrial rehabilitation without inflation. It can serve us equally in strengthening the sinews of production and progress.

Consumers have plenty of money to spend with take-home pay equal to the 1953 record and savings bigger than ever before. The problem is to stimulate a better flow of savings into risk-taking investment, assist the displacement of outmoded facilities which are wasteful of labor and material, increase the potential for efficient production, prepare for the growth of population and the betterment of living standards, give capacity to meet sustained upsurges of demand, and provide scope for producing new and im-

proved products to tempt the consumer to spend money he has got.

An increase in the personal income tax exemption, or a reduction in excise taxes, has a great appeal because the arithmetic is so simple. A dollar of revenues released in one of these ways leaves a maximum of a dollar more for consumers to spend. If business taxes are cut the answer is not so neatly prescribed. Under favoring conditions, as Dr. Arthur F. Burns of the President's Council of Economic Advisers has pointed out, a dollar's tax cut might induce business to spend $50. A new environment for business spending is created. Tax revenue may actually be enlarged. The real push is not exerted through dollars of revenues released but through giving the venturous a better set of figures to deal with in calculating ahead the benefits of a ten or twenty year investment.

The Forward Look

It seems paradoxical to some people that business men may be induced to put new plants in place when some existing types of goods are in temporary oversupply. But successful business men are forward looking and imaginative. They have been spending billions on research for product development. When the pressure of an overtime economy is off they have time to give attention to overworked and inadequate facilities and new product developments. In going ahead and putting plants in place they must feel assurance of a favorable environment and sources of equity as well as loan capital. In such an environment, they know from experience that business slumps will not last too long.

The decision to go ahead and put hard cash into brick and mortar is the boldest decision any business man is called upon to make. When undertaken, physical investment generates payrolls without adding anything in the first instance to the supply of goods. Thus, like government largesse, it primes the pump. But, unlike government largesse, it puts in place plant and equipment of enduring value to the community.

The vast majority of loyal and thoughtful citizens can agree with President Eisenhower:

> Our system of taxation must not only provide our Government with the resources to be strong for freedom's sake — but also enable our people to apply their initiative and industry fruitfully in an economy that is itself free and strong. This means taxes so adjusted as to fall where payment is least harmful — and so planned as to create jobs and expand the income of the mass of our people.

The Calamity That Didn't Happen

For more than a year the countries of the Free World have lived in dread of a business recession in the United States. Because of the importance of this country in world markets, and memories of what happened in 1929, 1937, and 1949, the peoples of other countries have taken it almost for granted that even a mild slump here would have calamitous effects upon their economies. The experience of 1949 was particularly frightening. At that time a mere leveling off in the rise of the U.S. national product and drop of 10 per cent in industrial production was enough to cause severe economic quakes abroad. With overall American imports then down by some 10 to 20 per cent, depending on the period measured, not only were foreign exporters supplying the American market hit but, worse still, the international balance of payments was thrown out of kilter, precipitating a currency crisis and new round of trade restrictions and currency devaluations.

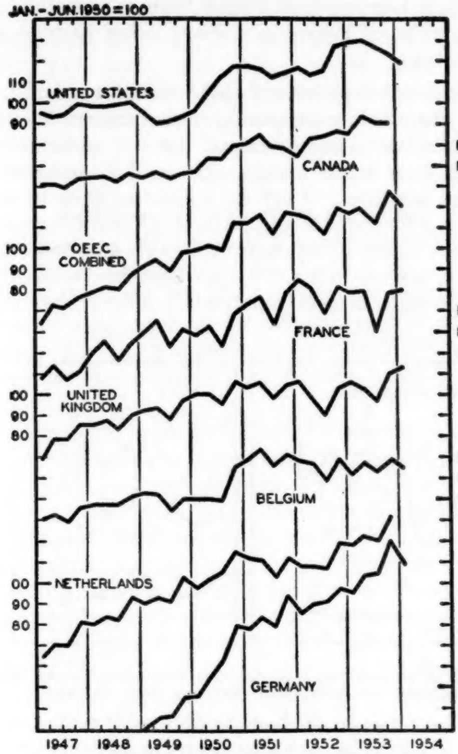
Haunted by these precedents, foreigners have feared that a new recession here, even if only a minor dip, might again upset the applecart. They have conjured up the spectre of mounting unemployment and new currency troubles — all threatening their hard-won gains towards internal recovery, freer international trade and currency convertibility.

This fear of an American setback has been one of the factors delaying the lowering of trade barriers and restoration of currency convertibility. Other countries have been reluctant to take chances in the face of their apprehensions of a new "dollar crisis" stemming from an American slump.

U.S. Dip Not Paralleled Abroad

Today the American business recession so widely feared abroad has become a reality. The rise in the U.S. national product has not only leveled off, but slipped a little, and the industrial production index is down about 10 per cent from the peak. American imports during the first quarter of this year were off about 10 per cent from the first quarter of last year — about the same decrease as was shown during the first quarter of 1949 compared with the first quarter of '48. Yet the dire predictions of the effects on the rest of the world have not been borne out. With some exceptions among raw material producing countries, industrial recovery abroad has held up or moved ahead.

That the American recession has had no counterpart in Western Europe is brought out by the following chart.



Indexes of Industrial Production in Leading Countries. (Not Adjusted for Seasonal Variation)

While, as will be seen, industrial production in Canada has sagged some, as it has here, the European countries covered in the chart show no halt.

The indexes for Germany and the Netherlands, as well as the combined index for the 17 Western European countries included in the Organization for European Economic Cooperation (OEEC), hit new highs in the closing quarter of 1953, and the index for the United Kingdom bettered its fourth quarter '53 record in the first quarter of '54. Production in Belgium held close to previous peaks, while the French index reached a new high in April. Dips recorded in the first quarter of this year for some countries are partly seasonal, and still leave the figures higher than for the corresponding period a year ago.

Recovery in Germany and the Netherlands has been particularly impressive, the German industrial index forging ahead to a level three times as high as in 1948 when far-reaching monetary reforms were carried out, and the Dutch index doubling since 1947.

Similarly, economic conditions are looking up in many non-European countries, including Australia, India, and South Africa.

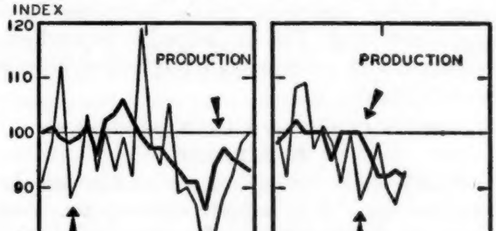
Nor are there any signs of a repetition of the international payments difficulties of 1949. The gold and dollar reserves of the Free World other than the United States continue to rise; in April the gain of $135 million for the sterling area's gold and dollar pool was the largest for any month in more than two years. Currency restrictions, instead of being tightened, are being progressively relaxed; hopes for continued advance in extending the area of free payments are the brightest since the end of the war. Actions by the Bank of England and by the German Central Bank in reducing their discount rates last month bear evidence of reviving confidence abroad, in striking contrast with apprehensions entertained a year ago.

In short, seldom have predictions of calamity gone more haywire. The question is, why have the prophets turned out to be so wrong?

Why Predictions Went Wrong

First, expectations of the impact of a business decline on American imports were probably exaggerated.

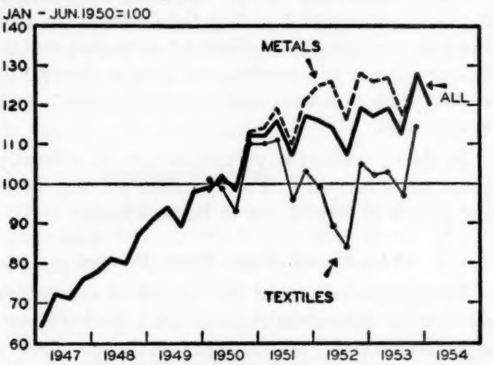
As indicated by the next chart, the decline in American imports in 1949 was heavily concentrated in the second quarter, when not only was the production index still receding but importers were withholding purchases in anticipation of currency devaluations which ultimately came in the early fall. In 1954 the production index is already showing signs of stabilizing, and the incentive to postpone normal importing in anticipation of currency devaluations is lacking.



Indexes of U.S. Production and Imports. (First quarter of 1948 and 1953 = 100)

Second, European monetary conditions are much better than in 1949. Inflation has been checked, prices are more competitive in world markets, money is sounder, and currencies are fortified by larger reserves.

Third, production in Western Europe rests on a broader base. In 1949 Western European indexes did not parallel the downturn in this country, due to pressing demands abroad for reconstruction. During that period, and also after the outbreak of the Korean War, the comeback of the consumer goods industries was impeded by the need for directing production into more essential channels and by the measures taken to control inflation. These trends are broadly depicted in the third chart showing for the 17 OEEC countries the course of textile production in comparison with that of metals and general industrial activity.



Indexes of Metal, Textile and Industrial Production Generally in 17 OEEC Countries.

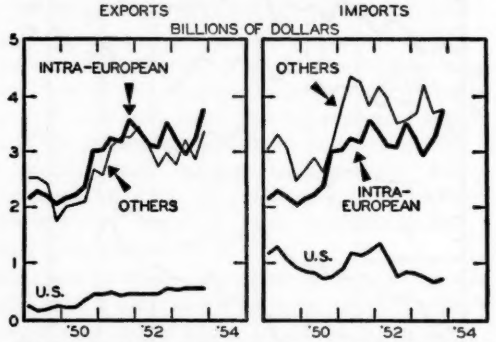
More recently, the build-up of industrial capacity and lessening of inflationary pressures have made it possible through elimination of rationing, reduction of taxes, and relaxation of credit restraints to give freer rein to consumption. While activities in the capital goods and metals industries have tended to level off as armament output has reached a peak and many postwar reconstruction projects have been completed, the consumer goods industries have staged a revival. This has helped to expand employment and carry overall production indexes to new highs.

Other Countries Less Dependent on U. S. Trade

Fourth, other countries have become less dependent upon U.S. imports and exports. They are trading more with one another.

For example, in the six months from last October through March British sales to the U.S. dipped 5 per cent below the like period a year ago, but sales to the rest of the world more than offset this dip, leaving Britain with a rising surplus of trade earnings. Likewise, slipping sales to the U.S. of some sterling area commodities such as wool, rubber, and cocoa, have been made up by increased sales elsewhere. And what is happening in British trade is repeated in the trade of France and many other European countries.

A broader picture of these trends appears in the chart below comparing trade between Western European countries and the U.S. since 1949 with their trade among one another and with other countries. It will be noted that their trade among themselves and with other countries has grown substantially, both in exports and imports. Their exports to the U.S. have likewise increased, while their imports from the U.S. have decreased.



Trade of Western European Countries with the U.S., with One Another (Intra-European) and with Other Countries.

The cause is not hard to divine. It is due, on the import side, partly to efforts to cultivate non-dollar sources in order to conserve dollar exchange, and partly to increased productivity in non-dollar areas, including Europe itself. On the export side, it reflects both the increased output of European industry and more competitive pricing, as already mentioned. At the same time, the expanding European consumption works naturally for increased intra-European exchange of goods as well as more trade with other countries supplying the European market. The better customers the European countries become of each other and of other non-dollar countries across the seas, the more they can expect to sell to the same countries, and vice versa.

Fifth, the so-called "terms of trade" have been in favor of European countries. By this is meant that prices of manufactured goods which bulk large in European exports have been higher relatively than prices of foodstuffs and raw materials which bulk large in imports. This tends to widen the spread between prices and costs to the benefit of European exporters, and to swing the balance of payments in favor of European countries, thus strengthening their exchange position.

At the same time, the relative steadiness of world prices of primary products in the face of

our business recession has spared the raw material producing countries much of the pain of additional deflation. By and large these countries took their price licking in 1951 and 1952 with the collapse of the post-Korean price bulge. By 1953 some of these economies were already stabilizing; others have enjoyed considerable recovery.

Influence of American Spending

Finally, a sixth and highly important factor softening the impact of the American recession upon the Free World has been the continued heavy outpouring of American funds for travel and other private services, economic aid, and support of our military efforts and those of our allies abroad.

Much has been said about the cutting back of economic aid — and the total has indeed been substantially reduced from the peak — but the amount still bulks large and is accompanied by increased spending in the military categories. Despite the declining trend of American commercial imports in the latter part of '53, aggregate dollar creating transactions last year reached a grand total of around $19.6 billion, only a shade less than in '52. And figures for the first quarter of '54 indicate spending at an annual rate not much below that of '53.

Dollar Creating Transactions

(In Billions of Dollars)

	1948 Official	1949 Official	1952 Official	1953 Official	First Q. 1953 Official	First Q. 1954 Anticip.
Goods and Services						
Commercial imports	$ 7.1	$ 6.6	$10.7	$10.9	$2.8	$2.5
U.S. Govt. spending for goods*	.7	.5	.8	1.0	.2	.3
U.S. Govt. spending for services†	.7	.6	1.7	2.0		
Travel and other private services	1.8	1.9	2.6	2.7	1.0	1.1
Subtotal	10.3	9.6	15.8	16.6	4.0	3.9
Gifts and Capital Movement‡						
Private gifts	.7	.5	.4	.5	.1	.1
U.S. economic aid	3.8	5.1	1.9	1.9	.5	.4
Private capital	.9	.8	1.1	.4	.2	.4
U.S. Govt. capital	.9	.6	.5	.2	—	(—.1)
Subtotal	6.3	7.0	3.9	3.0	.8	.8
Total Dollars Created	$16.6	$16.6	$19.7	$19.6	$4.8	$4.7

*Includes U.S. offshore military procurement. †Includes also expenditures abroad of U.S. personnel. ‡Excludes U.S. military aid grants.

A Test Well Stood

The foregoing review will, we believe, shed light on why the course of economic events in 1953-54 has proved to be so much at variance with 1948-49 and with prognostications based on that experience.

European countries have increased their production and consumption markedly in the past five years, and their economies are in better balance. Their dependence on us for manufactured goods has decreased, and they have been able to obtain increasing supplies of raw materials at moderate prices from non-dollar sources. Inflation has been checked, thus removing a root cause of balance of payments difficulties. In price, quality, and variety of merchandise, promptness of delivery, and terms of credit, Europe is becoming more competitive, Germany in particular putting up a stiff contest for world markets. Monetary reserves have been built up.

In sum, the notion that a mere ripple on the surface of the U.S. economy is enough to produce tidal waves elsewhere has been dispelled. The Free World has stood the test well.

To be sure, we are not yet clearly out of the woods. A deepening of the recession here could prove the gloomy forebodings of the economic Cassandras to have been more right than wrong. The 1953-54 episode does not warrant jumping to the conclusion that the outside world is now immune to any disturbance in this country. But with the business decline here leveling off, the chances appear to be diminishing that any severer test is at hand.

From the longer-range point of view there is still the question raised by the role that U.S. Government economic aid and extraordinary military expenditures abroad continue to play in making dollars available to foreign countries. As indicated by the table above, these expenditures in 1953 came to a total around $5 billion. In recent years they have contributed in large measure to the ability of foreign countries to cover their private trade and service account deficits with the U.S. and build up their gold and dollar reserves. A decline in these outlays would, unless accompanied by adjustments elsewhere, bring back the old trouble of the "dollar gap".

So far as the immediate future is concerned this does not seem likely to be a problem. Our economic aid, which includes assistance given to France and to the Indo-Chinese States, may well be almost as high in '54 as in '53. Nor are our military expenditures abroad likely to decline much in the face of present world tension. Consequently a further upbuilding of foreign gold and dollar reserves this year seems in the cards.

Nevertheless, the existence in international balances of payments of an element of such magnitude, which over the long run must be considered impermanent, cannot be ignored. It emphasizes the need of working towards conditions in world trade and credit where exchanges of private goods and services and private movements of capital will pay for each other.